

NORTH CAROLINA ILLUSTRATED



A VISUAL GUIDE TO TAX REFORM

Scott Drenkard
Director of State
Projects



nc>

North Carolina
Chamber
Foundation

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we value tax
systems that are

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pro-growth

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78 years



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at the
federal,
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& local levels

2015 State
Business Tax
Climate Index

by Scott Drenkard
Joseph Henchman



ABOUT THE TAX FOUNDATION



FACTS&FIGURES

HOW DOES YOUR STATE COMPARE?

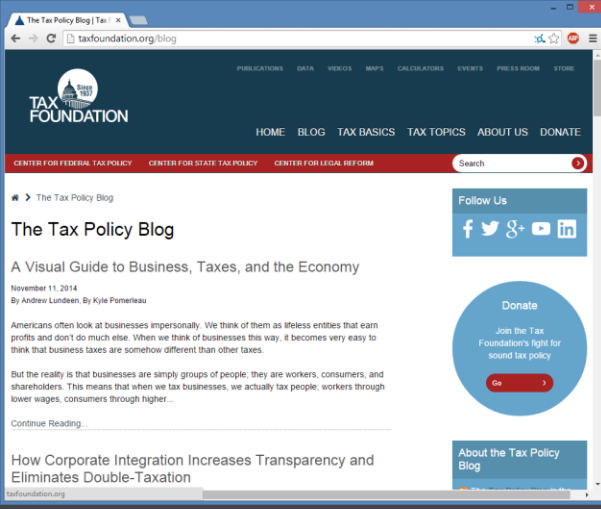
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2015 State Business Tax Climate Index

by Scott Drenkard
Joseph Henchman

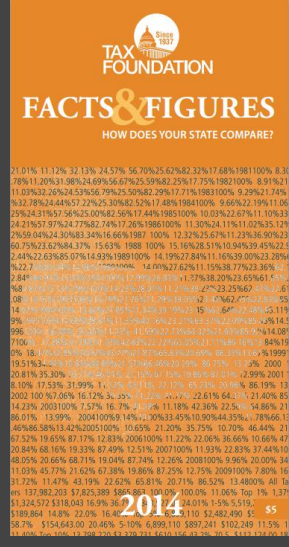


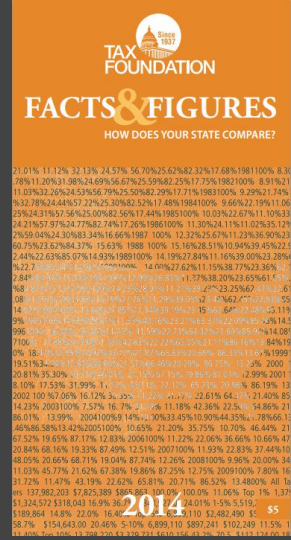
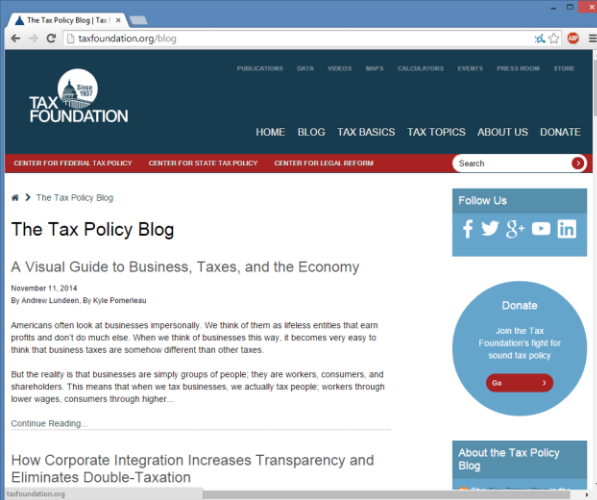


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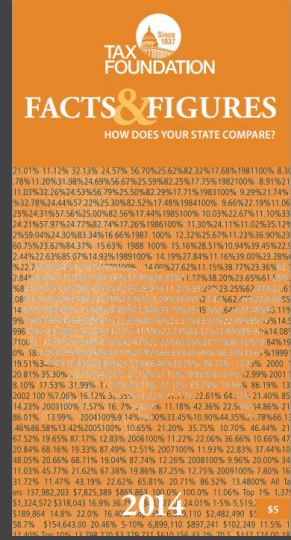
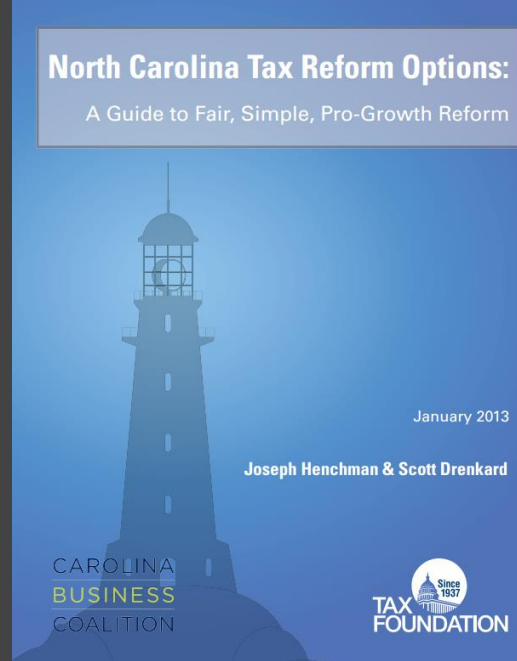
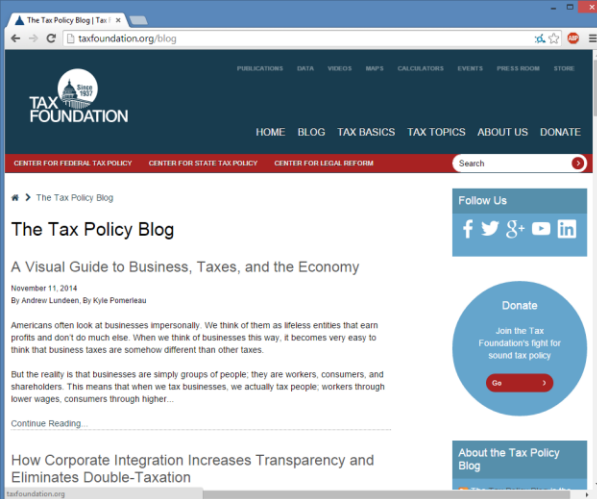


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	Senator Paul's tax reform plan would replace the current tax system with a 14.5 percent tax on wages and investment income, and a 14.5 percent tax on business profits and payroll.	The Economics Effects of Rand Paul's Tax Reform Plan
	Mr. Perry has not announced any details of his plan.	Waiting for details.
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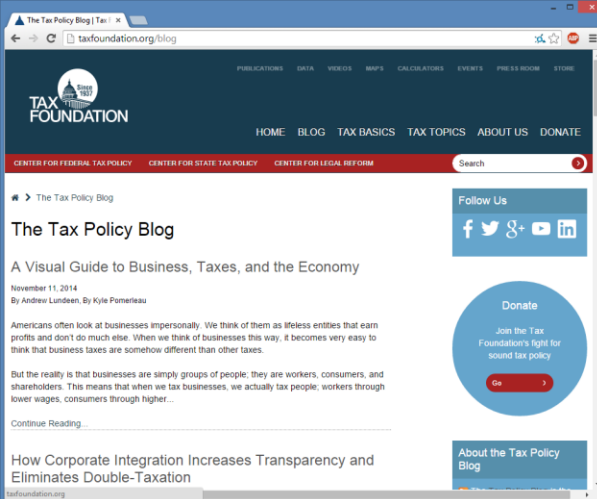


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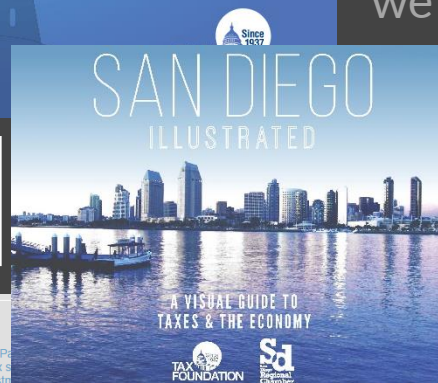
North Carolina Tax Reform Options:

A Guide to Fair, Simple, Pro-Growth Reform

CAROLINA
BUSINESS
COALITION

January 2013

Joseph Henchman & Scott Drenkard



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FACTS&FIGURES

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2015 State Business Tax Climate Index

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Senator Paul has not announced any details of his plan.



Rick Perry

Mr. Perry has not announced any details of his plan.



Marco Rubio

Senator Rubio has released the outline of a comprehensive proposal with Senator Mike Lee of Utah.



Bernie Sanders

Senator Sanders has expressed support for a financial transactions tax, a 65% top estate tax rate, and higher top marginal rates for individuals. He has not announced any further details at this time.

Tax Reform Plan

Waiting for details.

The Economic Effects of the Rubio-Lee Tax Reform Plan

Waiting for details.

THE
TAX FOUNDATION
TELLS A STORY

PART 1

North Carolina Before

Before its major tax overhaul, North Carolina was a state with a surprisingly high tax burden compared to its neighbors, coupled with a poorly structured tax code. Pre-reform, the Tar Heel State's tax system ranked 44th in the country—meaning that only six states had less-competitive tax codes than North Carolina.

In this chapter, we introduce North Carolina and the six key states we've identified as economic competitors for attracting people and business. We briefly walk through each state's economy before explaining the relative tax structure of each—including how they compare nationally and also to one another. We'll examine the relative tax burden of each state and delve into how North Carolina's tax code functioned prior to the implementation of the ongoing multi-year tax reform. Finally, we'll explore some key details about the North Carolina economy, including how it has fared over the business cycle, what kinds of jobs North Carolinians have, trends in disposable income, and geographic migration patterns.



Mock Judson Voehringer Company Hosiery Mill, Greensboro, North Carolina, photo: Rhpotter.

Tax Snapshot: Pre-Reform North Carolina and Six Competitors

State Business Tax Climate Index Rankings, North Carolina and Competitor States (as of July 1, 2013)

The *State Business Tax Climate Index* gauges how well structured each state's tax code is for business. States that score well on the *Index* have broad bases and low rates, but North Carolina had narrow bases and high rates on many taxes. North Carolina ranked 44th in the country prior to its reforms and had a worse rank than all six competitor states.

North Carolina



North Carolina Index Tax Component Breakdown

Corporate Tax Rank	30th
Indiv. Income Tax Rank	42nd
Sales Tax Rank	47th
U.I. Tax Rank	10th
Property Tax Rank	29th

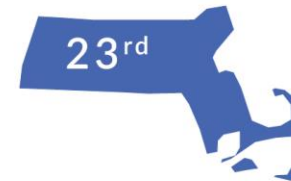
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia

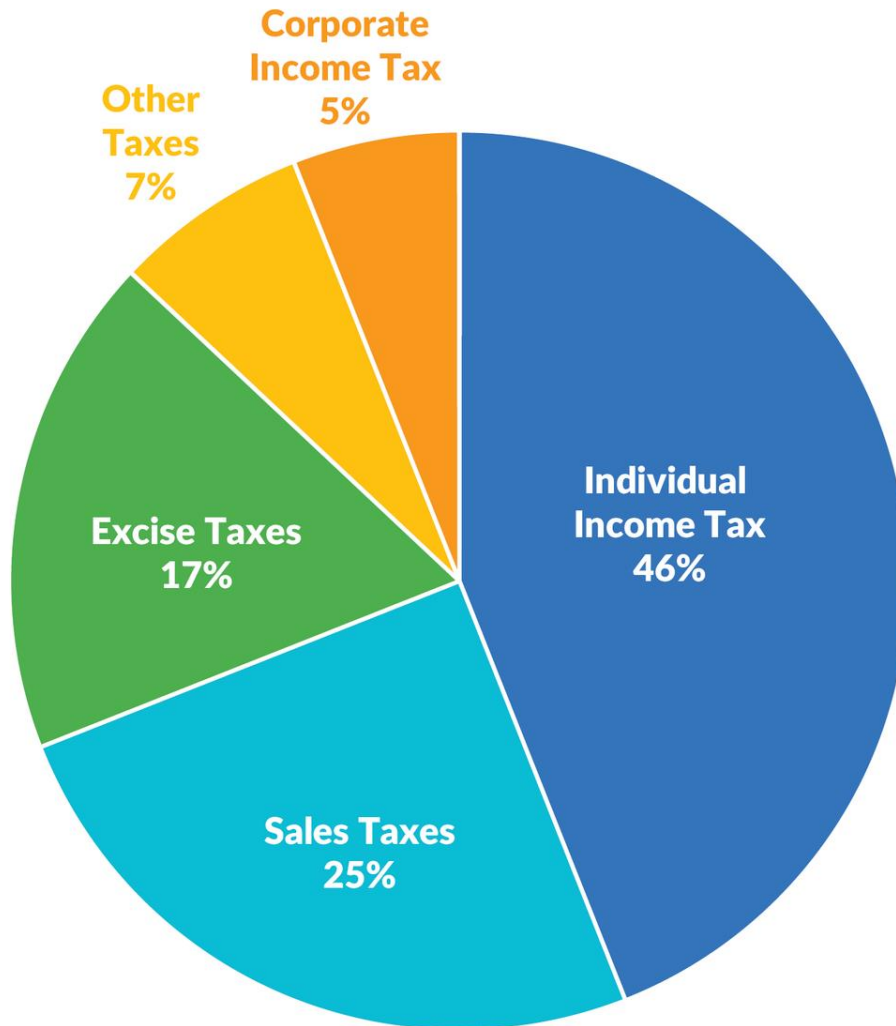


Note: This shows rankings based on 2014 *Index* scores, which are based on law as of July 1, 2013 (prior to the North Carolina reforms' effective dates).

Source: Tax Foundation, 2015 *State Business Tax Climate Index*.

North Carolina State Government Relied Most Heavily on the Individual Income Tax in 2012

Percent of Total Tax Collections by Tax Type, North Carolina State Government (FY 2012)



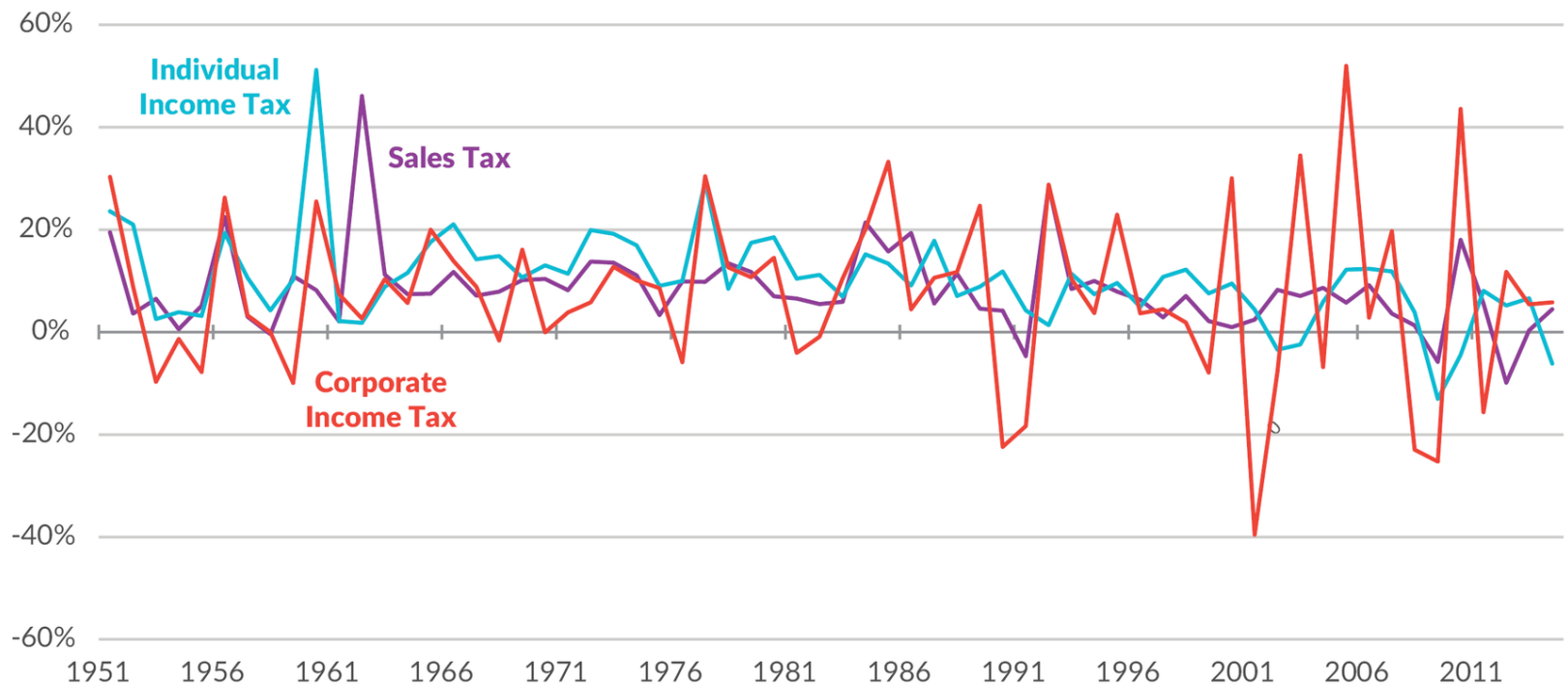
North Carolina obtained the largest share of state government tax collections in the 2012 fiscal year from individual income taxes (46 percent of total), followed by sales taxes (25 percent), and excise taxes (17 percent). As in most states, corporate income taxes make up the smallest share of state tax collections in North Carolina (5 percent) among major tax types.

North Carolina relied less on individual income taxes as a revenue source in fiscal year 2012 than Georgia (where individual income taxes made up 49 percent of state tax collections), Massachusetts (50 percent of state tax collections), and Virginia (56 percent of collections), but more than South Carolina (38 percent) and Florida and Texas, which don't levy individual income taxes. Sales tax reliance is much more prominent in Florida and Texas, which obtained 59 percent and 60 percent of their total tax collections from this source, respectively.

Source: Census Bureau, *State Government Tax Collections*.

Different Tax Types Respond Differently to the Business Cycle

Annual Percent Change in Tax Collections by Tax Type, North Carolina State Government (1951-2014)

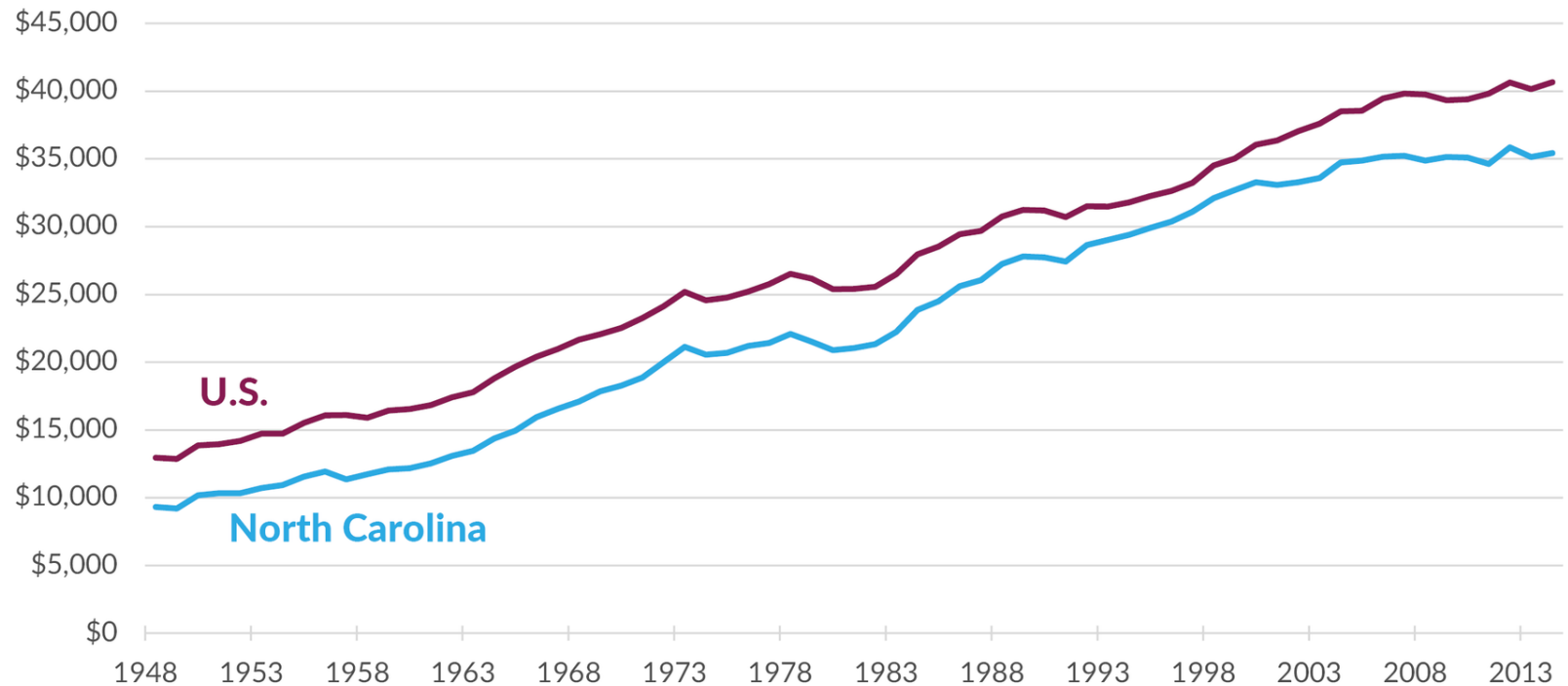


Revenue stability over the business cycle is an important facet of state tax policy. Different types of taxes react differently to changes in the economy. In North Carolina, corporate income taxes fluctuate the most, exhibiting pronounced year-to-year changes in collections over the past twenty years.

Source: Census Bureau, *State Government Tax Collections*.

North Carolinian's After-Tax Income per Person Has Always Been Lower than the U.S. Level

Disposable Personal Income per Capita, North Carolina and the U.S. (1948-2014, in 2014 Dollars)



Disposable income is a measure of income available after taxes are paid. North Carolina disposable income per capita has historically been below the U.S. average, though that gap began to close in the 1990s. Since the early 2000s, however, the gap has begun to widen again. North Carolina's disposable income per capita in 2014 was \$35,437, while the U.S. level was \$40,670 that year.

Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2014 base year.

Source: Bureau of Economic Analysis, *Annual State Personal Income and Employment*, "Disposable Personal Income Summary."

PART 2

The New North Carolina

North Carolina made sweeping changes to its tax code during the 2013 legislative session and built on those reforms in 2014 and 2015—enough to move the state from having the 44th best tax code in the country to the 13th best tax code in the country once reforms are fully phased in, according to the *State Business Tax Climate Index*.

The charts, tables, and maps in the following section outline the overall tax reforms made, and then zoom in on many of the major changes, providing both historical and geographic context. We explain the big changes made to the individual income tax, business taxes, sales taxes, and finally the estate tax.



Raleigh, North Carolina, photo: Mark Turner

Tax Reform Lowered Rates, Broadened Bases, and Made the Tax Code More Neutral and Simple

Overview of Major Tax Changes (2013, 2014, and 2015)



Individual Income & Estate Taxes

- Replaced graduated rates with one flat rate
- Lowered the individual income tax rate over several years
- Broadened the tax base by closing or limiting many income tax credits and deductions
- Expanded the Child Tax Credit and Standard Deduction (also known as the zero tax bracket)
- Repealed the state estate tax



Business Taxes

- Lowered the corporate income tax rate over three years with a further deduction subject to a revenue trigger
- Broadened the tax base by allowing many credits to expire
- Eliminated local business privilege taxes
- Phased in single sales factor apportionment which determines the percentage of a multi-state operation's total profits that are taxable in North Carolina, based on the percentage of sales made in the state

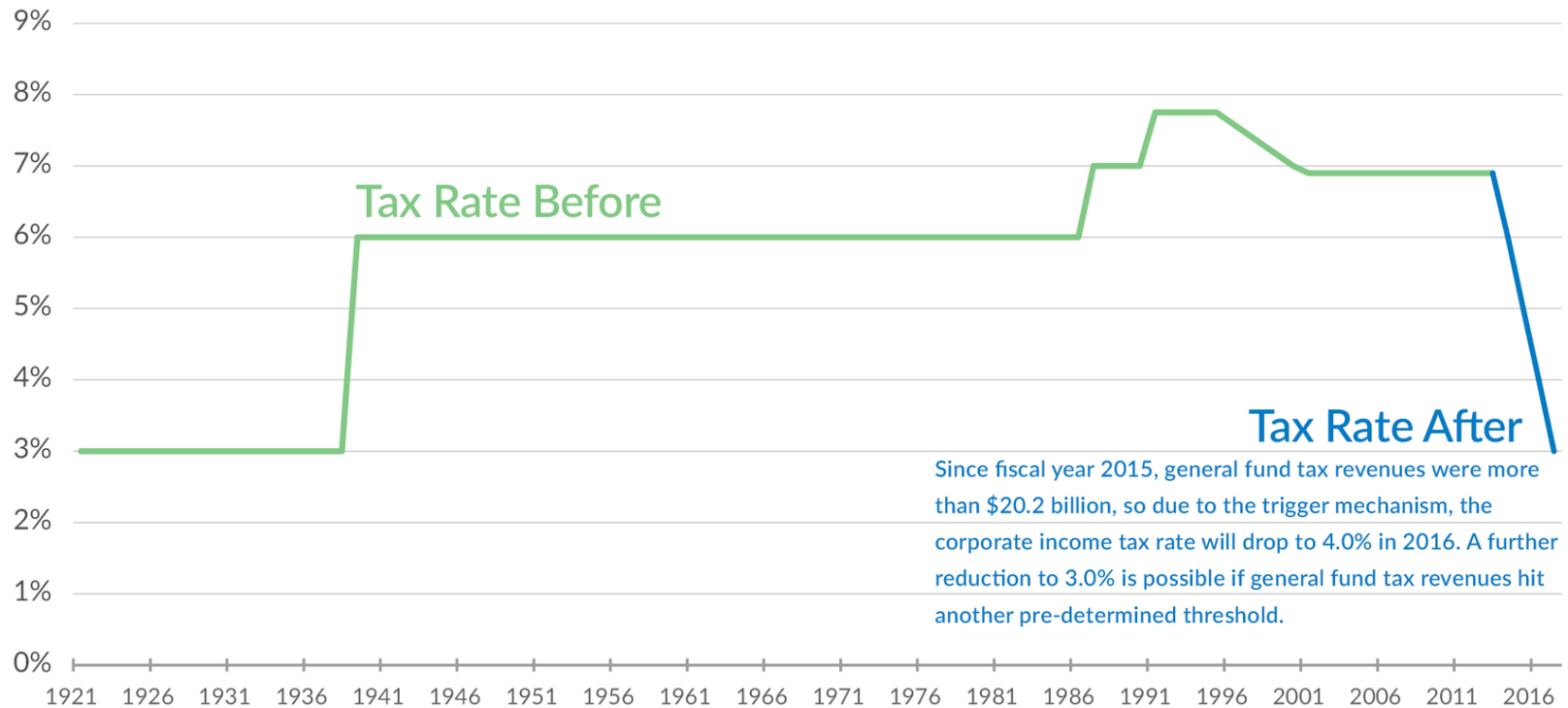


Sales Taxes

- Modestly broadened the sales tax base to include certain service contracts and repair or maintenance services associated with the purchase of tangible personal property
- Eliminated the state sales tax holidays
- Eliminated special sales tax rates for electricity, piped natural gas, amusements, and entertainment

Corporate Income Tax Rate: Before and After Reform

North Carolina Corporate Income Tax Rate, North Carolina (1921-2015)

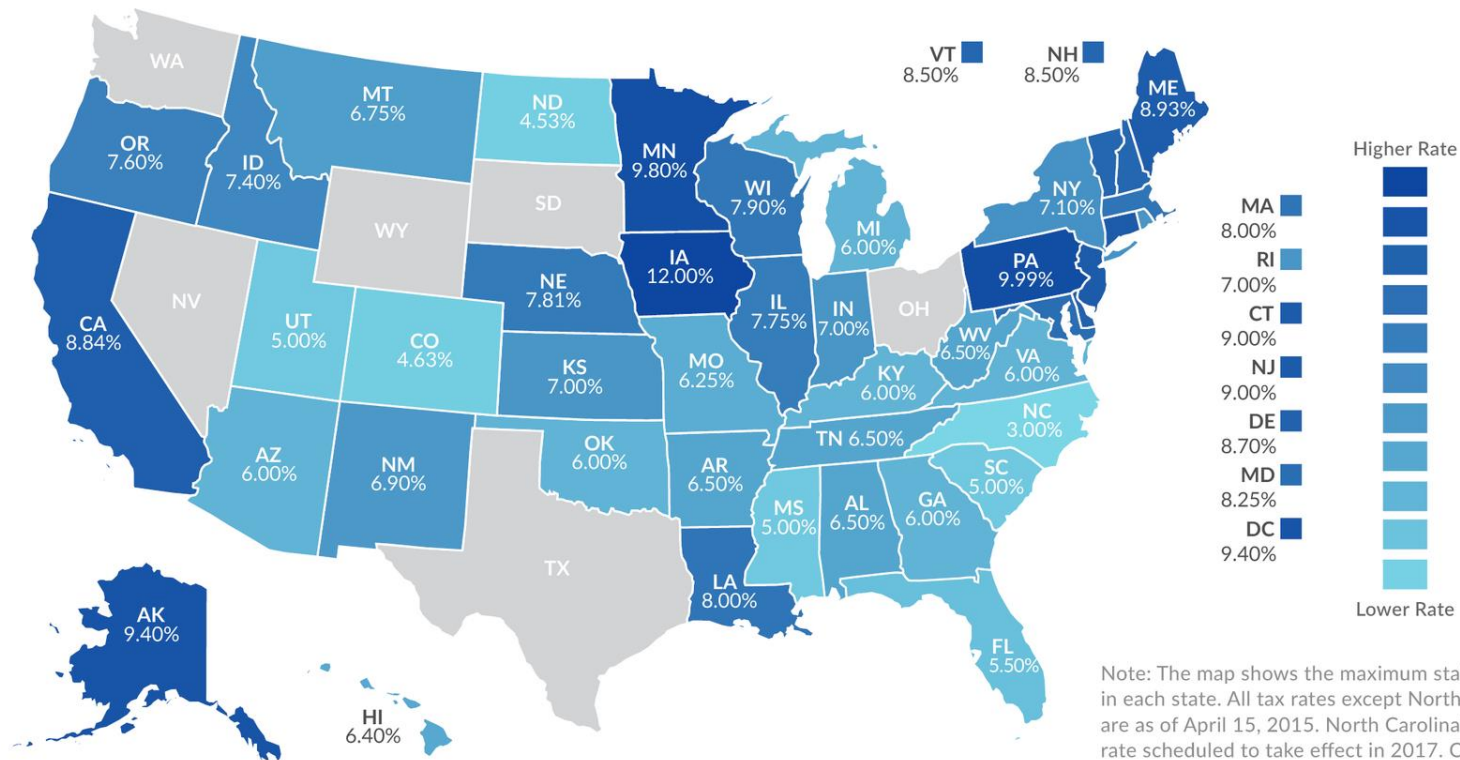


North Carolina's corporate income tax was enacted in 1921 at a rate of 3 percent. The rate increased over the years until it peaked at 7.75 percent in the early 1990s, then dropped to 6.9 percent in 2001. The rate did not change again until 2014, when it dropped to 6 percent, then to 5 percent in 2015. The tax reforms built in a "trigger mechanism," automatically reducing the rate in future years if revenue targets are met. The first target was met during the 2015 fiscal year, lowering the rate to 4 percent in 2016. If the next revenue target is met, the rate will drop to 3 percent, making North Carolina's corporate income tax rate the lowest in the country among the states levying corporate income taxes.

Source: State tax statutes; Interim Joint House and Senate Finance Committees, *Overview of North Carolina's Corporate Income Tax*, North Carolina General Assembly (Apr. 7, 2010).

North Carolina's Corporate Income Tax Rate Will Be the Lowest in the Country among the States that Levy One

Top State Marginal Corporate Income Tax Rates (as of April 15, 2015 unless otherwise noted)



Once North Carolina's new lower corporate income tax rate of 3 percent is phased in (assuming that the state meets the general fund tax revenue requirements outlined under the revenue trigger mechanism), North Carolina's tax rate will be the lowest in the country among states levying a corporate income tax.

Note: The map shows the maximum statutory tax rate in each state. All tax rates except North Carolina's are as of April 15, 2015. North Carolina's rate is the rate scheduled to take effect in 2017. Connecticut's rate includes a 20% surtax. Illinois' rate includes two separate corporate income tax rates. Nevada, Ohio, Texas, and Washington have statewide gross receipts taxes with rates not strictly comparable to corporate income taxes. Some states, including Virginia and Delaware, levy widespread local gross receipts taxes in addition to corporate income taxes.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare*; Tax Foundation, *North Carolina Budget Compromise Delivers Further Tax Reform*, Tax Policy Blog (Sept. 17, 2015).

Selected Business Taxes: Before and After Reform

Overview of Selected Business Tax Changes (2013, 2014, and 2015)

Business Taxes Before		Business Taxes After	
Local Privilege Taxes	Film Tax Credit	Local Privilege Taxes	Film Tax Credit
Municipal governments have the authority to levy license taxes on the privilege of doing business within a town or city, with no standard definition of “doing business” or the tax base across municipalities.	25% Of qualified expenses credited (\$20 million maximum)	None	Allowed to expire and replaced with a grant program

Source: Tax Foundation, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform* (Jan. 2013); Tax Foundation, *North Carolina Builds on Tax Reform, Repealing Burdensome Local Privilege Taxes* (June 5, 2014); Tax Foundation, *2015 State Business Tax Climate Index*; North Carolina Department of Revenue, Revenue Research Department, *Biennial Tax Expenditure Report* (Dec. 2013).

How Will North Carolina's New Corporate Taxes Compare?

State Business Tax Climate Index Corporate Tax Component Rankings, North Carolina and Competitor States (Projected)

Breaking the *State Business Tax Climate Index* into its subcomponents allows us to compare the structure of each major tax type. Here, we look at the structure of North Carolina's post-reform corporate taxes, after all tax changes have been phased in. Once all reforms are in effect, North Carolina will have the 4th best corporate tax code in the country and will outrank all competitor states' corporate tax structures.

North Carolina



Prior to the tax reforms, North Carolina's corporate taxes were 30th best in the country.

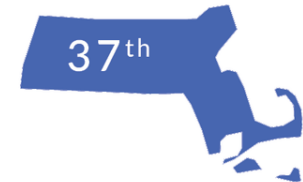
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia



Note: The figure shows the projected corporate income tax component ranking once all of North Carolina's corporate tax changes are phased in (including the 3 percent corporate income tax rate in 2017).

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

Sales Taxes: Before and After Reform

Overview of Sales Tax Changes (2013, 2014, and 2015)

Sales Taxes Before		Sales Taxes After	
Sales Tax Holidays	Sales Tax on Services	Sales Tax Holidays	Sales Tax on Services
Two tax-free weekends: <ul style="list-style-type: none">• Clothing, school supplies, computers, education software, and sports equipment (early August)• Energy Star appliances (early November)	Most service transactions exempted from the sales tax base	None (Both repealed)	Limited expansion of base to certain services, including service contracts and services associated with the purchase of tangible personal property
Miscellaneous Provisions		Miscellaneous Provisions	
Lower tax rates for electricity, piped natural gas, manufactured homes, mobile homes, amusements, and entertainment		Electricity, piped natural gas, amusements, entertainment, manufactured homes, and mobile homes subject to the full state rate Note that 50 percent of the cost of mobile and manufactured homes is exempt.	

How Do North Carolina's New Sales Taxes Compare?

State Business Tax Climate Index Sales Tax Component Rankings, North Carolina and Competitor States (Projected)

Breaking the *State Business Tax Climate Index* into its subcomponents allows us to compare the structure of each major tax type. Here, we look at the structure of North Carolina's post-reform sales taxes. Once all reforms are in effect, North Carolina will have the 33rd best sales tax code in the country. Its sales tax structure is outranked by all competitor states except Texas—meaning North Carolina still has plenty of work to do in this category.

North Carolina



Prior to the tax reforms, North Carolina's sales taxes were ranked 47th in the country (meaning that they ranked more favorably than only three other states).

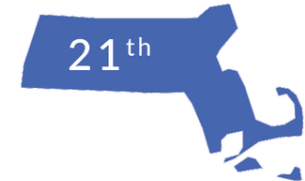
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia

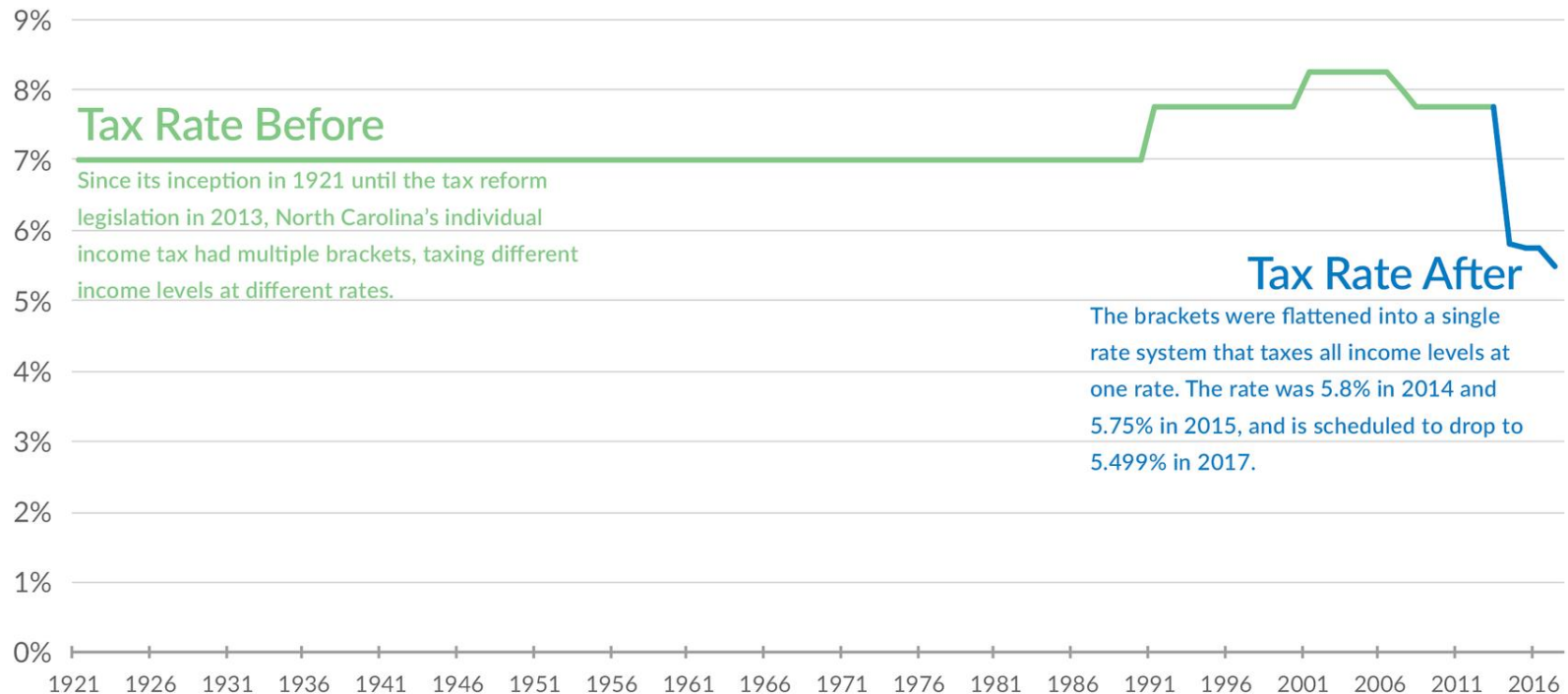


Note: The figure shows projected sales tax component rankings once all of North Carolina's sales tax changes are phased in.

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

Individual Income Tax Rate: Before and After Reform

Top Marginal Individual Income Tax Rate, North Carolina (1921-2015)

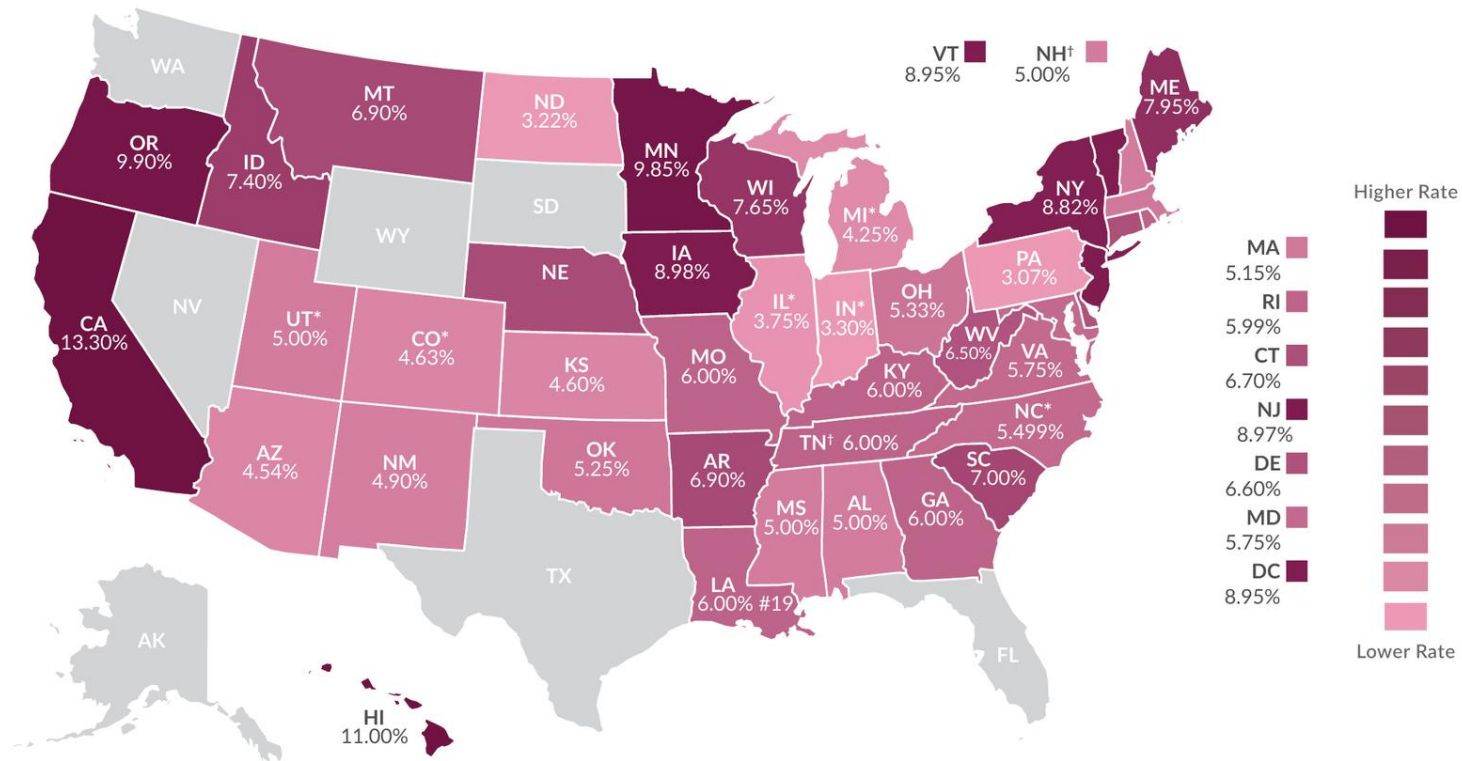


From its inception in 1921 through the 2000s, the North Carolina individual income tax had multiple brackets, with rates ranging from 3 to 8.25 percent. In 2014, the individual income tax changed dramatically to a flat rate of 5.8 percent on all income levels, followed by a further decline to 5.75 percent in 2015. The rate is scheduled to go down even further in 2017 to 5.499 percent, which would make it the lowest rate among our key competitor states levying an individual income tax.

Source: State tax statutes and forms; Roby B. Sawyers, *The History of State and Local Taxes in North Carolina – Changes in Sources and Burdens*, North Carolina State University (Nov. 28, 2006).

North Carolina's Individual Income Tax Will Be the Region's Lowest among States Levying an Income Tax

Top State Marginal Individual Income Tax Rates (as of April 15, 2015 unless otherwise noted)



Once North Carolina's new tax rate of 5.499 percent is fully phased in as of 2017, the state will have the 27th lowest top marginal rate in the country and the lowest among its neighbors.

Note: The map shows the maximum statutory tax rate in each state. The map does not include local income taxes. All tax rates except North Carolina's are as of April 15, 2015. North Carolina's rate is the rate scheduled to take effect in 2017. States with (*) have a flat income tax. States displaying (†) only tax interest and dividend income.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare*; Tax Foundation, *North Carolina Budget Compromise Delivers Further Tax Reform*, Tax Policy Blog (Sept. 17, 2015).

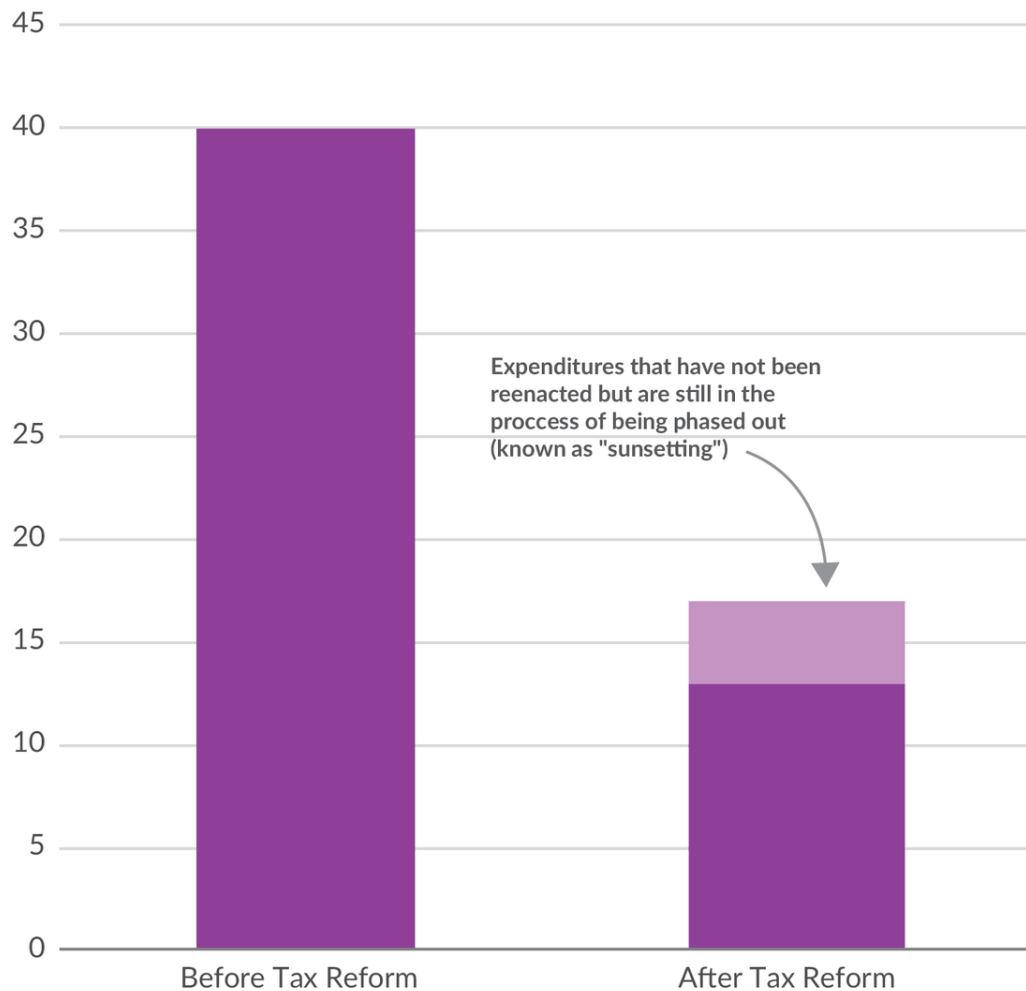
Individual Income Tax Base: Before and After Reform

Overview of Major Individual Income Tax Base Changes (2013, 2014, and 2015)

Tax Base Before			Tax Base After		
Standard Deduction	Personal Exemption	Child Tax Credit	Standard Deduction	Personal Exemption	Child Tax Credit
\$6,000	\$2,000	\$100	\$15,500	None	\$125
for Married Filers	per Person	for All Taxpayers	for Married Filers		for Married Filers
More if taxpayer is 65 years or older or blind	\$2,500 if income is less than \$100,000				if adjusted gross income is less than \$40,000
Credits & Deductions Available			Credits & Deductions Available		
Child care, disability, property taxes on farm machinery, education expenses, charitable contributions, retirement and social security income, severance income, certain bond obligation interest, state tax returns, long-term care insurance premiums, earned income, adoption expenses, business income, property taxes paid on primary home, and mortgage interest. Maximum allowable itemized deductions matches the Federal Tax Code.			Very limited types of retirement income, social security income, severance income, certain bond obligation interest, state tax returns, and itemized deductions which are limited to mortgage interest (capped), property taxes paid on primary home (capped), charitable contributions (unlimited), and medical expenses (unlimited). Deductions for interest and property taxes paid together is capped at \$20,000.		

North Carolina Tax Reform Broadened the Personal Income Tax Base by Eliminating More than Half of Its Tax Expenditures

Number of Individual Income Tax Expenditures, Before and After Tax Reform



An income tax expenditure is a tax preference (given via an exclusion, deduction, credit, lower rate, or some other means), making the tax on that income less than it would have been otherwise. There are tax expenditures that ensure a well-structured tax base, and there are those known as “policy decisions” that give preference to certain activities or income under the tax code. Policy decisions narrow the tax base, forcing the tax rate to be higher than it would be otherwise to raise the same amount of revenue.




North Carolina’s tax reform dramatically reduced the number of “policy decision” tax expenditures in the North Carolina individual income tax code. Eliminating existing tax preferences and broadening the tax base allowed lawmakers to lower the individual income tax rate for all taxpayers.

Note: Expenditures in existence “before tax reform” were taken from the December 2011 edition of the *Biennial Tax Expenditure Report*. “After tax reform” expenditures were taken from the December 2013 edition of the report.

Source: North Carolina Department of Revenue, Revenue Research Department, *Biennial Tax Expenditure Report* (2011 and 2013 editions).




How Does North Carolina's New Tax Code Impact Real People?

North Carolina's 2013 reforms had real impacts for real people. These six scenarios show how low- or high- income North Carolina taxpayers with or without children fare under the North Carolina income tax code, both pre- and post-reform.

		Before Reform	After Reform
Max Income: \$15,930 Filing Status: Head of Household		State Income Tax \$143 Effective Rate 0.9%	State Income Tax \$101 Effective Rate 0.6%
Harold & Betty Income: \$36,252 Filing Status: Married Filing Jointly	 Retired	State Income Tax \$0 Effective Rate 0%	State Income Tax \$0 Effective Rate 0%
Danielle Income: \$28,916 Filing Status: Single		State Income Tax \$1,412 Effective Rate 4.9%	State Income Tax \$1,231 Effective Rate 4.3%

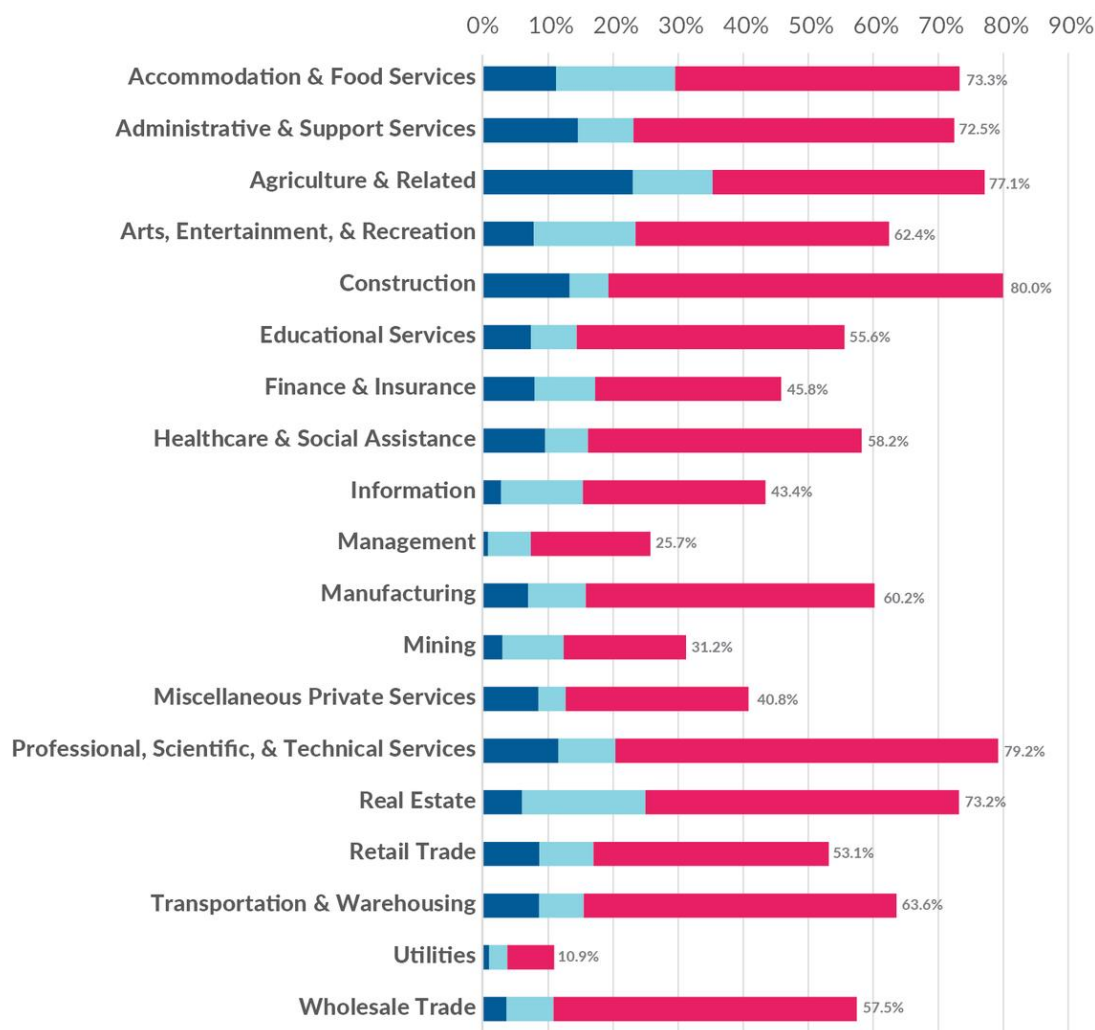
Note: All calculations are made for the 2015 tax year and reflect state statutes and tax rates as of January 1, 2015. This assumes an equal split of income between spouses, that all income was earned in the state of filing, that no estimated tax payments were made in advance, and that there were no interest or penalties charted. Icons are meant to show the number of exemptions claimed in each household.

Source: State statutes and forms; Tax Foundation calculations.

		Before Reform	After Reform
Jason & Nicole		State Income Tax \$3,352 Effective Rate 4.9%	State Income Tax \$2,884 Effective Rate 4.2%
Liz & Jack		State Income Tax \$16,551 Effective Rate 5.3%	State Income Tax \$16,987 Effective Rate 5.5%
Heidi & Bret		State Income Tax \$113,784 Effective Rate 6.2%	State Income Tax \$100,272 Effective Rate 5.5%

Individual Income Taxes Also Matter to Businesses

Percent of Employer Businesses that Are Pass-Through Entities by Sector, North Carolina Statewide (2013)



Firms that pay individual income taxes rather than corporate income taxes are known as “pass-through” or “flow-through” entities because business income “flows through” to the owner’s individual income tax return. Sole proprietorships, partnerships, and S-corporations are all types of pass-through businesses (note that LLCs are included in these categories by the Census Bureau).

Sixty-two percent of all employers with payroll in North Carolina are pass-through entities, but that share varies for specific sectors of the economy. It’s important to note, however, that when we consider the aggregate number of workers at businesses with payroll in North Carolina, most of them work at traditional corporations (known as C-corporations).

Sole Proprietorships

Partnerships

S-Corporations

Note: The chart does not include non-employer firms.
Source: Census Bureau, *County Business Patterns*.

How Will North Carolina's New Individual Income Taxes Compare?

State Business Tax Climate Index Individual Income Tax Component Rankings, North Carolina and Competitor States (Projected)

Breaking the *State Business Tax Climate Index* into its subcomponents allows us to compare the structure of each major tax type. Here, we look at the structure of North Carolina's post-reform individual income tax, after all tax changes have been phased in. Once all reforms are in effect, North Carolina will have the 14th best individual income tax code in the country. Among competitor states, it will be outranked by Florida and Texas (which don't levy individual income taxes), as well as Massachusetts (which has a lower flat rate at 5.15 percent).

North Carolina



Prior to the tax reforms, North Carolina's individual income tax was only the 42nd best in the country (in other words, it ranked better than only eight other states).

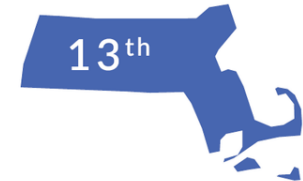
Florida



Georgia



Massachusetts



South Carolina



Texas



Virginia

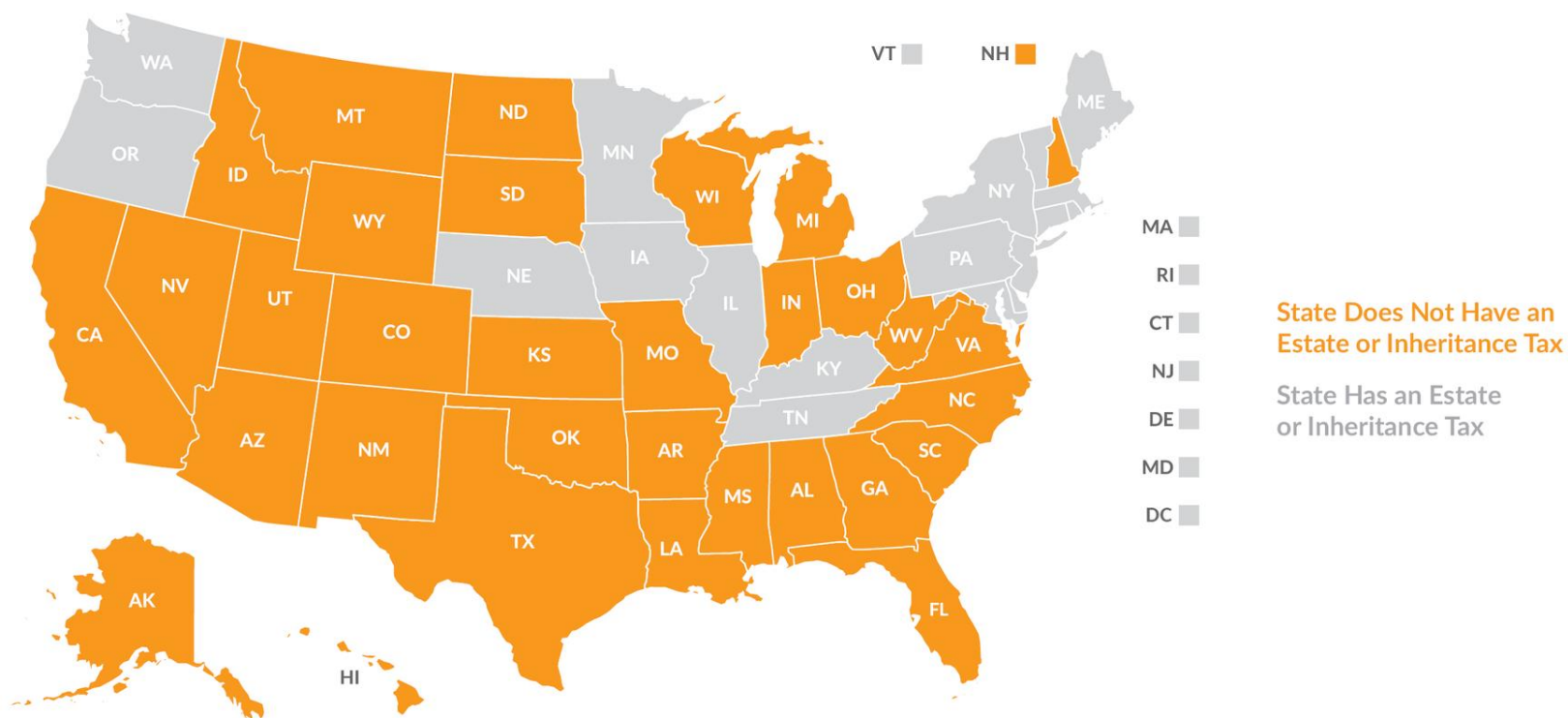


Note: The figure shows projected individual income tax component rankings once all North Carolina income tax changes are phased in (including the 5.499 percent rate in 2017). Florida ranks better than Texas because the *State Business Tax Climate Index* takes S-corporations and LLCs (which are taxed under the individual income tax code) into account, which are subject to taxation by the Margin Tax, a gross receipts tax in Texas.

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

North Carolina Joined 38 Other States without an Estate or Inheritance Tax

States without and with Estate or Inheritance Taxes (2015)

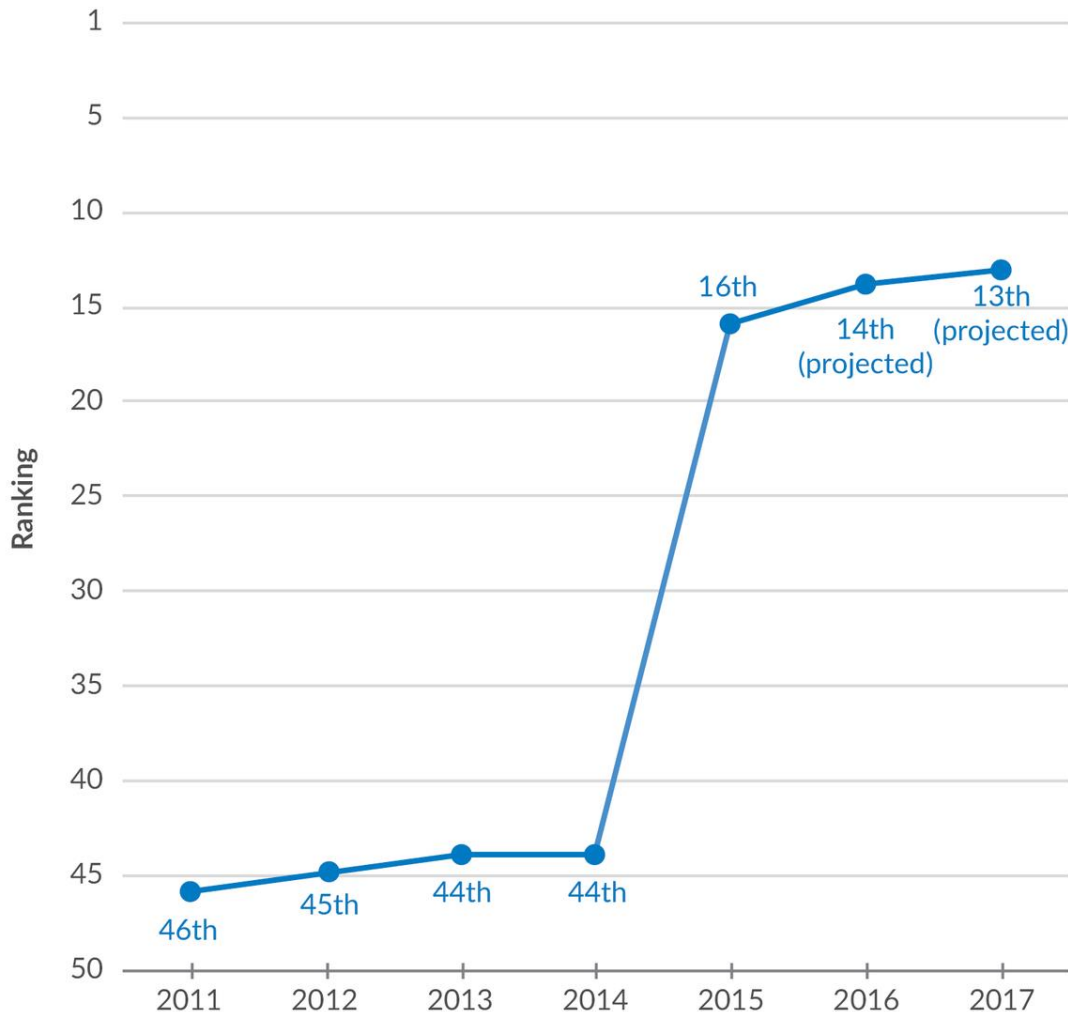


In addition to the federal estate tax, many states levy their own estate and inheritance taxes. Estate taxes are charged directly against the estate, while inheritance taxes are levied on inheritors, based on their relationships to the deceased. Fifteen states and the District of Columbia have an estate tax, and six states have an inheritance tax. Maryland and New Jersey have both. North Carolina repealed its estate tax—a smart policy move given death taxes' high compliance costs, detrimental economic effects, and low share of total state tax collections.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare?*

North Carolina's Tax Climate Used to Be One of the Worst but Is Now One of the Best

State Business Tax Climate Index Rankings, North Carolina (2011-2017)



Our *State Business Tax Climate Index* compares the structure of state tax codes on over 100 variables to determine which states have the best and worst climates for business. The result is a relative ranking of all 50 states, in which a ranking of 1 indicates the best climate for business and a ranking of 50 indicates the worst.

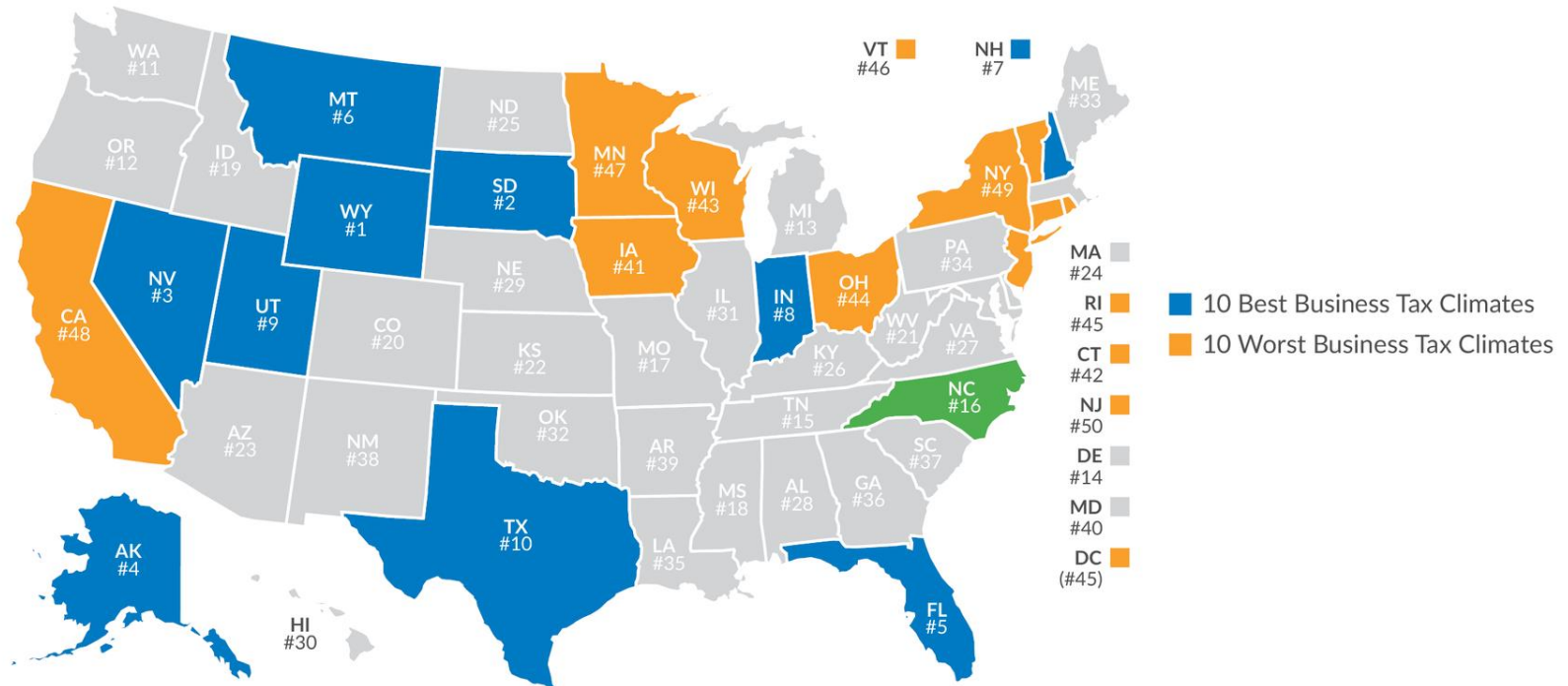
Prior to North Carolina's historic tax reforms, the Tar Heel State was in the bottom ten, ranking 46th in 2011 and moving up slightly to 44th in 2013 (we've chosen 2014 *Index* scores as our "before" snapshot, since they reflect laws as of July 1, 2013, which was before any tax reform legislation took effect). Post-reform, North Carolina's ranking skyrocketed to 16th best in 2015. It's expected to reach 13th best once reforms are fully phased in and the revenue trigger is met.

Note: Projected rankings use 2015 rankings as a baseline. That is, North Carolina's scheduled future changes are considered alongside the tax codes of other states as of July 1, 2014 (the start of the 2015 standard state fiscal year).

Source: Tax Foundation, 2015 *State Business Tax Climate Index*; Tax Foundation projections using the *State Business Tax Climate Index* model.

In 2015, North Carolina's Tax System Was Better than 34 Other States' Tax Systems

State Business Tax Climate Index Rankings (2015)



The absence of a major tax is a common factor among many of the top ten states in the *Index*. Wyoming and South Dakota have no corporate or individual income tax; Alaska has no individual income or state-level sales tax; Florida and Nevada have no individual income tax; and New Hampshire and Montana have no sales tax. Indiana and Utah, on the other hand, have all of the major tax types, but levy them with low rates on broad bases, earning them spots in the top ten as well. The states in the bottom ten all suffer from the same afflictions: complex, non-neutral taxes with comparatively high rates.

Note: A rank of 1 indicates the state's tax system is more favorable for business; a rank of 50 indicates the state's tax system is less favorable for business. The (*) next to North Carolina's rank indicates that the 16th best score is the state's 2015 score, an improvement from 44th best in 2014. The state is projected to improve even further to 13th if all planned reforms continue as scheduled.
Source: Tax Foundation, 2015 *State Business Tax Climate Index*.

A photograph of two brown horses standing on a sandy beach. The horse in the foreground is facing left, and the one behind it is slightly to the right, also facing left. The ocean is in the background under a clear blue sky.

PART 3

What's Next for North Carolina?

The sweeping tax reforms made in the Tar Heel State shouldn't be the end of the road. North Carolina could still make improvements to its tax structure, especially when it comes to broadening bases.

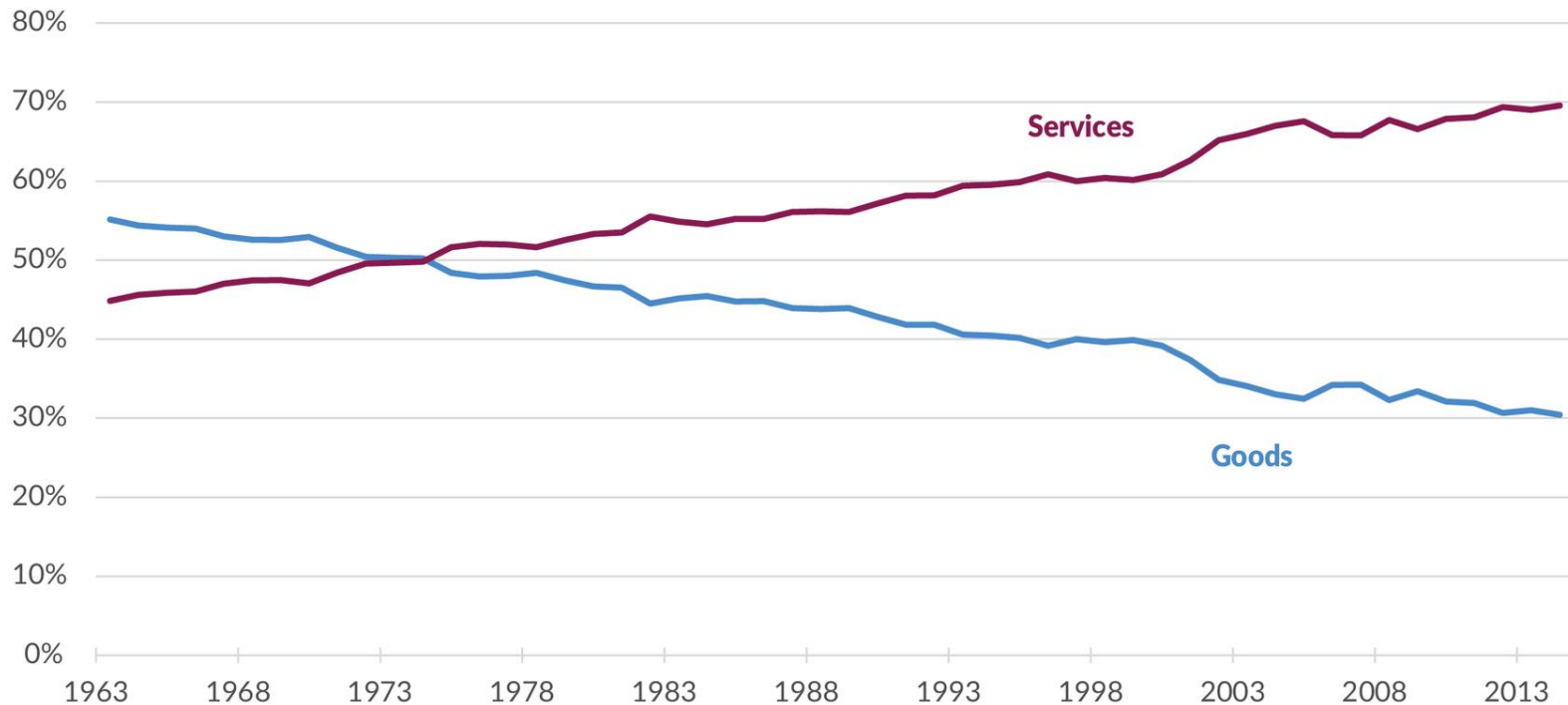
In particular, North Carolina still has narrow sales and corporate income tax bases. By broadening both of these, overall rates could be reduced, making North Carolina even more competitive nationally. The state has made moderate strides toward sales tax base broadening in the last several years, but a main component of the modern economy is still missing from the base: consumer services.

On the corporate income tax side, North Carolina still has several business tax incentive programs that narrow the tax base and make the tax code less neutral, forcing the overall tax rate to be higher than it would be otherwise.

Finally, North Carolina still has a capital stock tax, a tax that less than half of the states impose and that's a deterrent to capital formation—which is no way to encourage economic growth.

North Carolina's Sales Tax Base Doesn't Reflect the Modern Economy

Goods and Services as a Percent of Total State Private Gross Domestic Product (1963-2014)

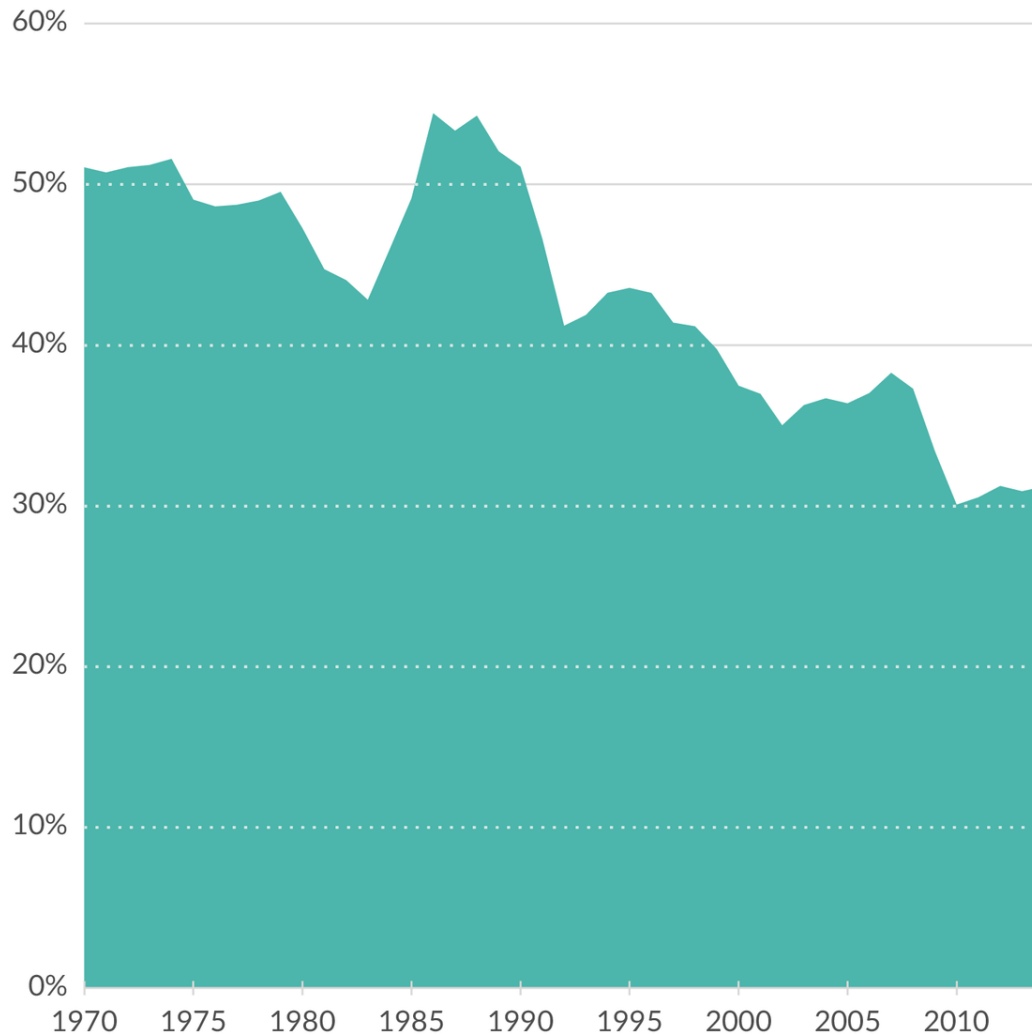


North Carolina has historically been more dependent on goods production than the U.S. as a whole due to its more pronounced manufacturing sector. But like all states, the share of the total economy that involves the production of goods has declined over time as the services share has grown. Fifty years ago, 55 percent of the North Carolina economy was derived from goods production, while only 30 percent came from goods in 2014. This has far-reaching implications for the sales tax base, which traditionally focuses on the taxation of transactions involving the exchange of tangible goods, not services.

Source: Bureau of Economic Analysis, *Gross Domestic Product (GDP) by State*, "GDP in current dollars."

As the Economy Has Shifted toward Services, the North Carolina Sales Tax Base Applies to Less and Less of the Economy

North Carolina Sales Tax Breadth (1970-2013)



An ideal sales tax is one that is levied on all final consumer purchases. By taxing a large number of transactions, the rate can be kept low and still raise sufficient revenue.

When sales taxes were created in the 1930s, they were levied on tangible goods, which at the time comprised the lion's share of the overall economy. However, the economy has become increasingly service based, and as a result, the sales tax is not nearly as productive as it once was. Furthermore, by failing to tax consumer services, the sales tax inherently favors the service sector of the economy over the goods sector—a major obstacle to tax neutrality. A solution to this problem is adding more final consumer purchases to the sales tax base.

Note: Sales tax breadth is defined as the ratio of the implicit sales tax base to state personal income.

Source: Professor John Mikesell, Indiana University.

North Carolina Has 51 Base-Narrowing Corporate Income Tax Expenditures

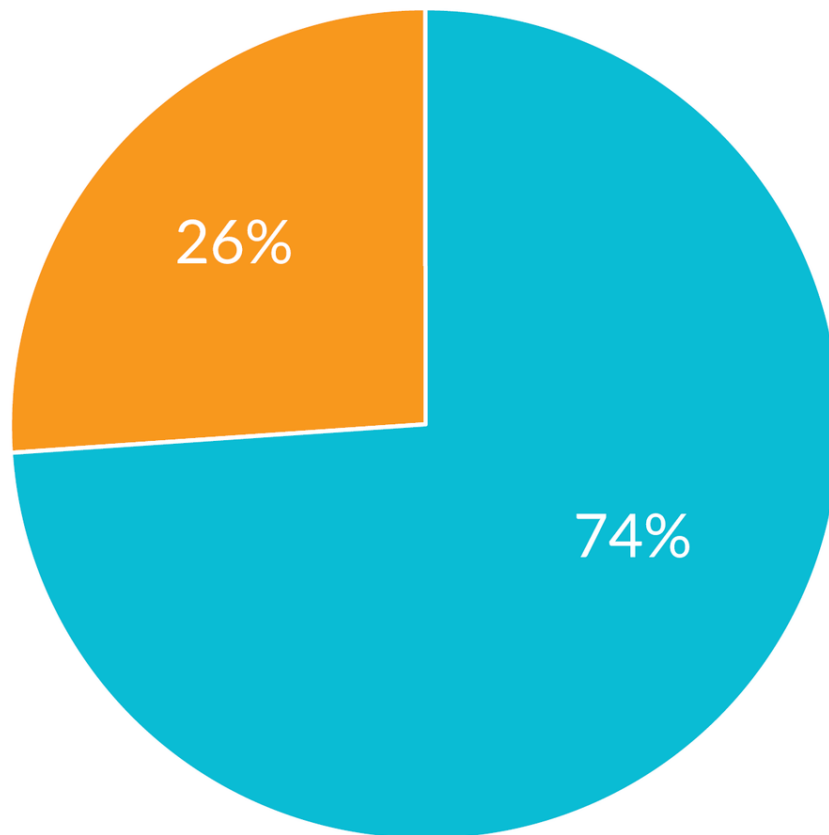
Number of Corporate Income Tax Expenditures (December 2013)

Administrative & Structural

18 Tax Expenditures

Policy Decisions

51 Tax Expenditures

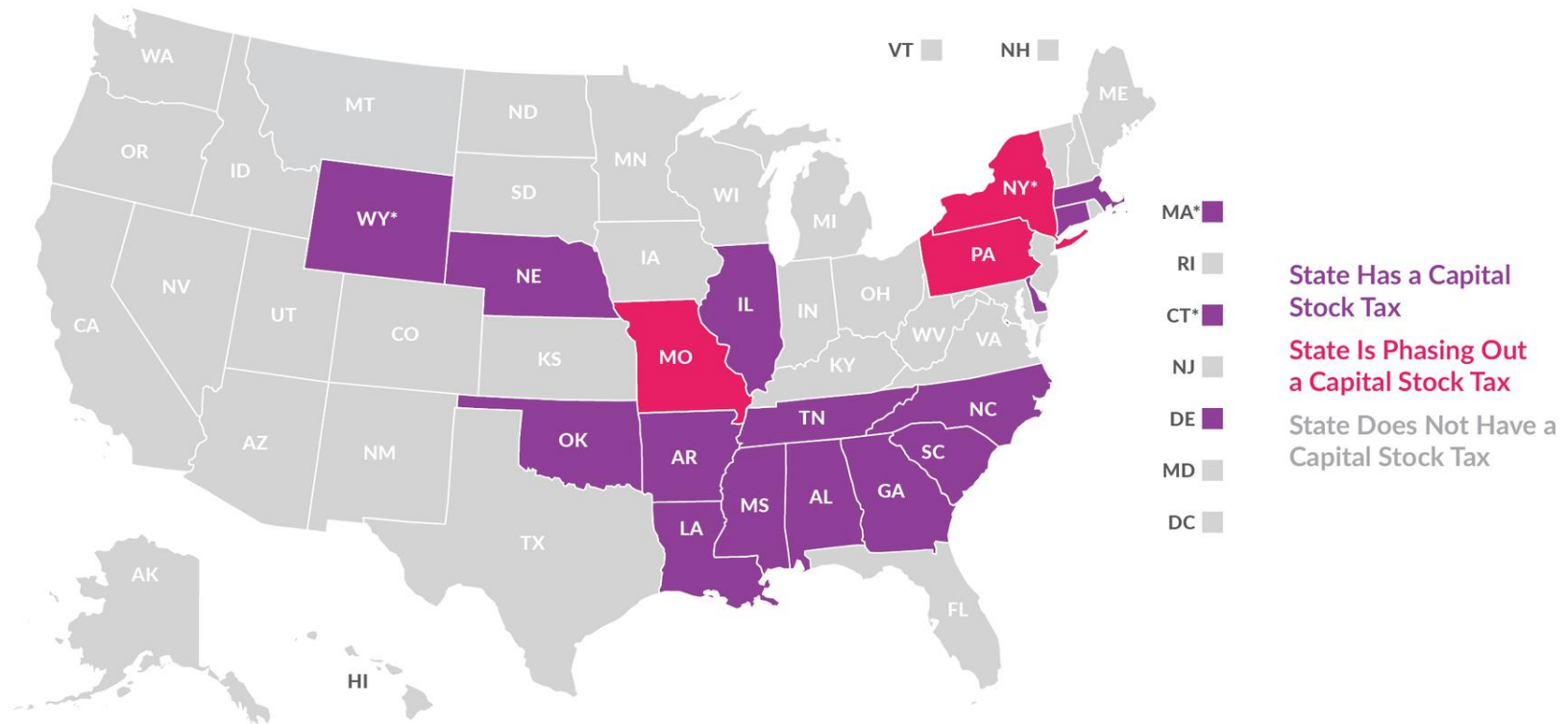


While North Carolina had a total of 69 corporate income tax expenditures on the books in their most recent *Tax Expenditure Report*, it's important to distinguish between different types of expenditures. Administrative and structural provisions are tools used to ensure the proper definition of income, avoid double taxation, and account for intergovernmental transactions. Approximately 26 percent of North Carolina's corporate income tax expenditures fall into this category. The remaining expenditures are carve-outs that are meant to encourage certain behaviors by businesses (such as moving toward renewable energy or creating jobs), but ultimately narrow the tax base, lead to a non-neutral tax code, and frequently fail to bring about the desired outcomes. A better approach to tax policy is to eliminate these types of tax expenditures so that the rate for all firms can be reduced.

Source: North Carolina Department of Revenue, Revenue Research Division, *North Carolina Biennial Tax Expenditure Report 2013* (Dec. 2013); Tax Foundation categorization of tax expenditures.

North Carolina Is One of Only 18 States that Levies a Capital Stock Tax

States with and without Capital Stock Taxes (as of January 1, 2015)



Fewer than half of the states in the U.S. levy a capital stock tax, an economically damaging tax imposed at a low rate but directly on business capital. These taxes are levied on the net assets or market capitalization of a business entity. The North Carolina capital stock tax is formally known as the “Franchise Tax” and is levied at a rate of 0.15 percent, with no limit on the maximum payment. These taxes discourage capital formation and are a deterrent to economic growth and development.

Note: Missouri, New York, and Pennsylvania are in the process of phasing out their capital stock taxes. Rhode Island and West Virginia just finished phasing out their capital stock taxes. (*) indicates that taxpayers pay the greater of corporate income tax or capital stock tax liability, but not both. See Table 33 of Tax Foundation, *Facts & Figures 2015: How Does Your State Compare* for more information on each state's capital stock tax rate and maximum payment.

Source: Tax Foundation, *Facts & Figures 2015: How Does Your State Compare?*

Questions?

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